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April 21, 2008

AGENDA ITEM 7a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Credit Enhancement Program Update
- II. PROGRAM:** Global Fixed Income
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

At the February 19, 2008 Investment Committee (IC) meeting, the IC requested that staff return in April to provide an update of the auction rate market in California and strategies for the Credit Enhancement Program (CEP) to assist California municipal issuers through the current liquidity crunch.

Due to the credit deterioration of monoline insurers and the lack of liquidity support from broker-dealers, more than 70% of the auctions have failed. Issuers are finding themselves paying an unexpected high penalty interest rate (as high as 20%), putting an onerous burden on municipalities throughout California and the nation. The total outstanding auction rate market is approximately \$330 billion with public finance representing 50% or \$165 billion. California state and local agencies have an estimated \$27 to \$30 billion auction rate securities outstanding as of February 2008.

The failure in the auction rate market and resulting liquidity contraction in the public finance sector is a serious concern for many regulatory bodies including the Treasury and IRS. The Treasury and IRS recently collaborated and clarified its regulations to provide additional flexibility for state and local governments to reissue or exchange bonds to remove insurance without tax implications. Many issuers have and will be taking advantage of the ruling and convert their auction rate securities into other forms of short-term municipal obligations.

Although banks, regulators, issuers, and bond counsels are working to restructure the auction rate securities into other forms of short-term debt, the size of outstanding auction rate bonds makes liquidity a scarce product for all issuers. CalPERS' CEP has received an unprecedented number of inquiries to provide liquidity and credit enhancement for conversions into variable rate demand obligations and other financing structures. Staff has reviewed auction rate conversions in various geographic areas with numerous credit enhancement banks and bank syndications. Since our last update, staff has been in contact with various enhancement banks to partner on California transactions and has indicated interest on \$200 million California auction conversion transactions with an additional \$165 million currently in the closing process.

While staff has been involved in the conversion of California auction securities into other financing vehicles, the CEP is restricted under the IRS Code to enhance 25% of each series or sub-series of any single California transaction. The restriction imposed by the IRS Code impedes our ability to lead transactions and imposes a structural problem for the municipalities that are considering using CalPERS as a credit or liquidity provider in the auction rate conversion process.

Despite the IRS limitation, staff is actively engaged in researching and developing broader strategies to assist municipal issuers in California and nationwide. The CEP will continue to aggressively deploy its capacity in order to alleviate the current market disruption. Staff will report back to the Board at the next IC meeting if municipal market conditions deteriorate further.

V. STRATEGIC PLAN:

This item supports Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

This item is not expected to have any material cost impact other than costs associated with managing the Credit Enhancement Program.

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